

2-1-1994

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Recommended Citation

Roberto Zahler, *The Background, Rationale, and Success of Chilean Economic Policy—A Speech by Roberto Zahler*, 16 Loy. L.A. Int'l & Comp. L. Rev. 275 (1994).

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LOYOLA OF LOS ANGELES INTERNATIONAL AND COMPARATIVE LAW JOURNAL

VOLUME 16

1994

NUMBER 2

The Background, Rationale, and Success of Chilean Economic Policy

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I. INTRODUCTION

My talk will begin with a broad, but brief, introduction regarding the situation in Latin America today to provide a framework for a discussion about recent Chilean economic policy. I will then address some general issues on Chilean economic policy. Finally, I will focus on the specific role of the Central Bank of Chile within this economic policy.

II. STRUCTURAL REFORM AND ADJUSTMENT IN LATIN AMERICA

Nearly eleven years ago, in August of 1982, the Latin-American debt crisis began. Mexico was not able to pay the interest it owed to its creditor banks. Along with Mexico, almost in a domino effect, most Latin-American countries suffered the same situation. In my view, it is very important to determine the origins of the debt crisis because we need to avoid the possibility that history will repeat itself. The origins of that crisis are evident in two sources: (1) domestic mistakes made by countries in their internal economic policy; and (2) mistakes made by commercial international banks in their assessment of the risk for loans made to Latin-American countries. The latter element is directly related to the Oil Shock of 1973, when oil-producing countries received huge revenues out of increases in the price of oil. The oil-producing countries could not

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absorb all of the revenues in foreign currencies within their own economies, so they had to be recycled. These resources were recycled in a very specific way. Most of them were deposited in international banks. The banks, in turn, increased their exposure in developing countries, particularly in Latin America, but without adequate analysis of risk conditions. This was perhaps the first time in many, many years—at least in this century—that banks made loans to countries for general balance of payments purposes and not for purposes of financing foreign trade or specific projects.

As a result of the debt crisis, net capital inflows to the region became negative, and most countries were not able to pay the interest on their debt, not to mention the amortization of that debt. Therefore, most Latin-American countries had to face a lack of foreign exchange and engage in profound adjustment policies in order to conform with International Monetary Fund and World Bank recommendations for restructuring their economies and economic policy. Because of the debt crisis, the 1980s are considered to be a “lost decade” for most of Latin America. The Latin-American nations slipped into a recession. As a result, investment, output, and wages fell dramatically; high unemployment and accelerated inflation were the norm rather than the exception; and almost every economic indicator for Latin America reflected poor performance.

Today, however, there is a new wave of optimism throughout most of Latin America because growth has, once again, resumed. In 1991 and 1992, growth averaged 3% per year. Thus, it is safe to say that the general mood of optimism throughout the region is well-founded. First, in most countries, there is a general trend towards more democratic, participative, and open political societies. Second, there have been major improvements in macroeconomic policy design and implementation. Third, regarding microeconomic issues, enterprises have been modernized and their feasibility increased in order to enable them to compete abroad with other countries presently involved in international competition. Finally, and perhaps most importantly, there is a movement throughout the region towards the implementation and/or acceleration of major reforms in the areas of tax, finance, and social security. Further reforms have occurred in the commercial area by reducing barriers to trade, lowering and homogenizing import tariffs by en-

sureing real and stable exchange rates, and gradually removing restrictions on international capital flows.

Each of these elements is a conference subject in itself. The point I would like to emphasize, however, is that there is a wave of optimism in Latin America emanating from these changes. The Latin-American countries are realizing that they can and must play a very important role in the design and implementation of economic policy and that the responsibility for their future lies in their own hands and not solely in those of the major industrialized countries. Although it may sound contradictory, this is completely consistent with the realization of Latin-American countries that their economic destiny is linked to the world economy because they are opening their economies to trade and finance.

III. CHILEAN ECONOMIC POLICY

Chile has a small economy. With a population of 13.5 million inhabitants, Chile's gross domestic product ("GDP") is approximately 40 billion dollars, and GDP per capita is about 3,000 dollars. Chile's small economy places certain constraints on the way in which it designs its development policy. This will be discussed in detail later.

Given the events in the last twenty to thirty years, there are two significant challenges for a country like Chile. The first challenge is to enter the twenty-first century with a society that strives to accomplish the following: minimize its social conflicts; increase its productivity and competitiveness; lengthen the time horizon for economic agents, both national and foreign, regarding investment decisions; and, in general, promote something that has not been traditional in Chile—cooperation rather than confrontation. This has not happened in the last thirty years, but I believe that because of our recent experiences, in addition to what we have seen in other Latin-American countries, it is reasonable to be optimistic regarding this first challenge.

The second challenge is to combine a market economy with stability, and economic growth with social development, in the framework of an open, free, and democratic political system. The combination of these three elements—market economy, social development, and an open political system—has not been the tradition in Chile nor in Latin America generally. Here again, I think

that the lesson learned from past experiences lends confidence to the feeling that we can successfully face this challenge in the future.

A. Chile's Road to Success

There exists today certain structural elements in Chile which I think are important to mention. Chile has a relatively educated and qualified labor force. In order to successfully improve the value added to our exports, we must allow for reallocation of laborers from certain sectors of the economy that lose competitive advantages to other sectors of the economy that gain competitive advantages in the process of the internationalization of the Chilean economy. Nonetheless, when you compare our labor force with that of other countries in Latin America, it is relatively well-trained.

Chile has a generous endowment of natural resources, a modern and sophisticated financial system, and high standards in all areas of communications. Furthermore, our public institutions have reduced bureaucracy and the civil service has high moral standards. These elements contribute to the grounded mood of optimism in facing the challenges previously mentioned. Lastly, I would reiterate that this optimism originates in the past experiences of Chile and the rest of Latin America, and in the general attitude of trying not to repeat the mistakes that we have made in the past.

B. Maintaining Macroeconomic Equilibrium

One of the lessons learned from past mistakes, which relates specifically to my position as President of the Central Bank, is the high degree of consciousness in our country regarding the importance of maintaining what we call macroeconomic equilibrium. This process basically involves controlling inflation, avoiding balance of payment crises, and ensuring minimum levels of employment for the population. It is quite impressive to observe the conscious recognition of the importance of macroeconomic equilibrium on the part of the leaders of the intellectual and political sectors in Chile, as well as the business communities and labor unions.

I would like to stress this consciousness because of the rather abstract nature of macroeconomic equilibrium. It is the intangibility of this concept that would lead one to believe that very few people or institutions are concerned with maintaining such equilib-

rium. In spite of this, we do have a high regard for stability and sound macroeconomic management. Perhaps this is because we experienced extremely high levels of inflation in the early 1970s and high unemployment in the mid-1970s and mid-1980s, coupled with both past and present experiences of other countries in Latin America—in terms of high inflation and balance of payment problems. Maintenance of macroeconomic equilibrium is a necessary condition for building a foundation for Chilean society, so that it may develop in a reasonable and increasingly participatory manner. In order to elaborate on some of the elements behind Chile's economic policy, I will refer to four areas in which there is a national consensus.

1. The Role of the Private Sector

The first area of national consensus relates to the role of the private sector in the economy. Today, there is a wide consensus that the private sector—both national and foreign—is the main force for development in the Chilean economy. This consensus was not commonly held in the past. Foreign investment in Chile today constitutes approximately 4% of its GDP, a very high rate on a worldwide basis. This represents the international community's confidence in the Chilean economy and its recognition that Chile's legislation is nondiscriminatory and nondiscretionary toward foreign investment. At the same time, overall private investment has increased substantially in recent years. In 1992, private investment increased by 25% in real terms, and we expect this year's increase to be above 15%. The Chilean economic policy should be built around the central objective that the rate of investment growth should exceed the rate of output growth. In other words, capital accumulation, such as equipment and inventories, should exceed overall aggregate output increases and should therefore be one of the main sources of growth of the Chilean economy.

2. The Role of the Market Economy

The second area of national consensus has to do with the role of the market economy. Again, this has been an area of great discussion in Chile and throughout Latin America in the past. Today, the prominent philosophy is that free prices, determined a competitive market, should be the norm and that the exceptions to this should remain exactly that—exceptions. One major exception is

minimum wages, which, for social considerations, are determined by means of a non-market method. Another exception involves interest and exchange rates, which are uncontrolled prices, and yet, they are not entirely market-determined prices because of their importance in the economic policy and development strategy of Chile.

Interest rates are the main instrument through which the Central Bank of Chile attempts to control aggregate demand and reduce the rate of inflation. The latter is our main target. Therefore, we influence interest rates in such a way as to try to have a diminishing rate of inflation. At the same time, the exchange rate is a crucial factor in determining resource allocation, division of labor, and investment decisions between what we call tradeable and non-tradeable goods sectors: those related to exports, imports, and import substitution activities. This price, though not controlled, is in a sense "filtered" by the Central Bank through its policy. This filtering occurs because we believe that the behavior (time-path) of that price is crucial for resource allocation in the Chilean economy.

The experience we had in the late 1970s, just before the foreign debt crisis, and the experience that some countries are now undergoing by allowing the market to determine the exchange rate predispose the economy to significant problems. For example, there is a trend, especially for foreign creditors—be they foreign direct investors, suppliers or creditors, private banks, or institutional investors (such as pension funds)—to behave in a procyclical way. These institutions tend to lend money to or invest in countries when the countries are, in relative terms, doing well and there is less need for money from abroad. If a country like Chile, for example, permitted this influx of resources into the country without any filter or restrictions and allowed the exchange rate to be market-determined, at some point the currency would appreciate to such a degree that many exporters (and particularly many non-traditional exporters, who are one of the main sources of growth of the Chilean economy) would become less competitive in the world markets. Once the same foreign creditors examine the current account of the balance of payments and see that it is deteriorating—and it will deteriorate if the exchange rate depreciates—they will send their profits, interest, capital, and amortization abroad. Yet, this is the precise moment when foreign exchange problems are

imminent and when there is a need for more foreign financing in the country. Therefore, the exchange rate would fluctuate, giving erroneous and misleading signs to investors in the tradeable sector. This is something we try to avoid.

In general terms, the Chilean economy is quite vulnerable to foreign shocks, such as a turnaround in the international prices of some commodities, world interest rates, and/or the major foreign creditors' perceptions of the country's creditworthiness. Therefore, we need to follow-up that price in the economy. In Chile's case, we have certain regulations that are designed to create a situation in the balance of payments that is compatible with medium- and long-term overall macroeconomic equilibrium in which the exchange rate is not solely market-determined.

The interest rate is also not solely market-determined, although the market certainly is a significant factor. This is the case because the interest rate is one of the main instruments of monetary policy used to achieve a stable and gradually decreasing inflation.

3. Chile Should Be an Open Economy

The third element of national consensus is the belief that Chile should be commercially and financially open, that is, an economy that is increasingly integrated into the world economy. There are several reasons for this belief. The first reason is the size of the Chilean economy. Because the domestic market is small, we need wider markets than the Chilean market alone to benefit from economies of scale and the division of labor. Experience shows that lowering trade barriers and multilateral open markets play an important role in the substantial increase of Chilean exports. Second, exports of goods represent approximately 25% of the Chilean GDP and exports of goods and services represent around 35% of the GDP. Therefore, for example, a 10% increase in exports alone implies a 3% increase in output.

a. Trade

One example in this area is the export of copper, which traditionally amounted to more than 70% of total Chilean exports. Today, copper exports represent approximately one-third of total exports, while other traditional exports, including other minerals, fruit, fishmeal, and pulp, account for another one-third. The last

third, which amounts to nearly 3.3 billion dollars of non-traditional exports, includes a great variety of goods going to many different markets. Examples of these non-traditional exports are wine, salmon and other fresh fish, wood chips, fruit juice, and canned foods. I emphasize that these latter exports represent nearly one-third of total Chilean exports. This is one of the main elements that characterizes Chile and distinguishes it from other countries. We follow these exports because they are one of our main sources of growth. In fact, although the world economy has not been very buoyant in recent years, these exports have increased by an average of 20% every year during the last five years. Chilean exporters have profited from this increase because the quantity of these exports is relatively small in absolute terms and does not threaten domestic markets in more developed countries nor in Latin-American countries. Thus, it is likely that the export of these products will continue to increase.

To explain what has happened with the exportable sector in Chile, I will compare the year 1985 with 1992. In 1985, we exported to 99 countries; today we export to 131 countries. Furthermore, the number of exporters has increased from 2,300 in 1985 to 5,400 in 1992. The number of items that were exported increased from 1,000 in 1985 to more than 3,400 in 1992, while the value of exports increased from 3.8 billion dollars to 9.9 billion dollars. Additionally, exports have diversified by region; Asia, Europe, Latin America, and North America each receive approximately one-third of our exports. Therefore, we have a diversified structure of exports in both products and markets. This diversity is extremely important because it provides the necessary stability to the process, where exports are the main source of economic growth. The average annual rate of growth of non-copper exports has been approximately 15%, while non-traditional exports have increased even more rapidly, doubling their share in the GDP between 1980 and 1990 from 9% to 18%.

b. Foreign Direct Investment

In addition to trade, the degree of consensus regarding the openness of the Chilean economy also relates to foreign direct investment. In relation to other countries, Chile receives some of the largest amounts of foreign direct investment, even though Chile does not have the most liberal legislation in this regard. Until re-

cently, foreign capital had to stay in Chile for at least three years before it could be remitted abroad. Today, remittance is permitted after one year and, as in many Latin-American countries, capital can be repatriated in twenty-four hours. I believe, however, that Chile should not adopt an extremely liberal policy, at least not suddenly or abruptly, for several reasons. First, we want a reasonable degree of stability. Second, we want to be sure that these investments are really going to the production or service sector of the economy and that they are not short-term capital that can easily leave the country whenever the economy falters.

In recent years, Chile has gradually but consistently opened its capital account to the world financial markets. For example, we have authorized American Depository Receipts ("ADRs"). This means that Chilean private corporations have successfully issued shares that are traded on the New York Stock Exchange. The Central Bank has been cautious with regard to companies entering into this market, and is particularly concerned about the sequence and amounts of foreign capital sought. More companies will follow the path, but again within a clear-cut strategy. We do not want a flood of money going to enterprises that might not meet our standards of excellence and might tarnish Chile's name and even jeopardize other companies' chances of obtaining financing from the international capital markets at reasonable prices.

Chilean companies will soon begin issuing bonds abroad. This is something no private Chilean company has done before. With regard to ADRs' policy, we will be cautious because the Chilean economy has relatively high interest rates. Many companies would like to issue bonds abroad because they can get financing at lower costs. Although that behavior may be rational for individual companies, it could have negative macroeconomic implications for the Chilean economy, including over-indebtedness, excess expenditure, and overvaluation of the currency, all of which we attempt to avoid.

Despite its success in the foreign sector, or really because of it, Chile presently has no program with the International Monetary Fund ("IMF"). Correspondingly, there is no balance of payments problem that requires us to seek financial assistance from the IMF. The price of Chilean debt in the secondary market—that is, the debt that originated in the foreign debt crisis—is near its face value and is one of the highest among medium-income countries. This

indicates that the international community has confidence in the way in which Chile is serving its foreign obligations. Therefore, many of the debt-equity swap schemes that were important between 1985 and 1990 are almost nonexistent today, and investors do not benefit from the debt-to-equity conversions. This is another sign that the country's creditworthiness is improving. Additionally, Chile has been the first Latin-American country to be rated as what is called "investment grade" by Standard and Poor's. This can be considered a "brand of quality," reducing the risk of investment in Chile.

Thus, it is safe to say that, from both trade and financial investment perspectives, it is important for Chile to have an increasingly open economy. Yet, the speed, nature, and sequencing of that openness must be cautiously designed and prudently implemented to prevent huge movements in the exchange rate and/or spending, which may destabilize the economy and create disruptions, forcing Chile to engage in a go-and-stop-and-go policy.

4. The Role of the Public Sector

The fourth issue on which there is a large national consensus is the role of the public sector. In principle, the share of public sector spending in the GDP should not increase. In fact, government spending has decreased from 34% in 1985 to less than 25% in 1992. The role of the public sector in Chile has changed significantly in comparison with its traditional role in Latin America.

Today, there is a general agreement that the public sector must fulfill three functions. A very important function is the social role of the public sector. Here, we refer to areas in which there is no direct interest by the private sector and where social public spending, therefore, is required. This includes, for example, the poor, education, nurseries, and healthcare. From an economist's perspective, this represents investment in human capital. It could also be characterized as striving for a more stable and egalitarian society. The state must give its under-privileged more opportunities through this kind of social spending.

Besides being efficiently focalized on those most in need, this particular kind of spending, as well as overall government spending, should be constrained by the kind of financing the government can get in a "healthy" way. That is, the norm should be to work within the funds derived from Parliament-approved taxation and

not by getting indebted abroad or within. Two years ago, Chile passed tax reform legislation that allowed the Chilean Government to increase substantially its social expenditure. Thus, state social spending in general is understood within the framework of maintaining macroeconomic equilibrium.

The second function regarding the role of the state, or the public sector, has to do with the regulatory function. This is extremely important in some areas related to the Central Bank. I am referring to the financial system—specifically, to the whole issue of supervision and regulatory aspects of banking and/or other institutions, such as pension funds, where public faith is being deposited. Regulation is also required in areas of natural monopolies, environment, and in all those areas where property rights are poorly defined, where there is sort of an explicit or implicit guarantee of the state, or where there are some clear market imperfections that require regulation by the government. This is an area that is relatively unexplored and in which we have had little experience in Chile. We are convinced, however, that smooth and proper functioning of the market will require professional, technical, and sound regulatory institutions to ensure timely prevention of market failures through yellow lights and not through red lights once the damage is done.

Finally, the third function relates specifically to macroeconomic equilibrium, and it is here that the Central Bank has a key role to play.

IV. THE ROLE OF THE CENTRAL BANK

Chile now has an independent central bank that functions as a linear combination between the United States' Federal Reserve System and Germany's Deutsche Bundesbank. The Central Bank does not, at this stage, have the history of the Federal Reserve or the Bundesbank, but it is similarly structured.

The Central Bank cannot finance the government, and does not receive instructions from the government or from anyone else. The Bank is, however, required to coordinate its policies with the government as long as that coordination does not attempt to jeopardize the Central Bank functions, which are to stabilize the value of money and to ensure the normal due payment of foreign debt and of external payments in general.

In economic terms, the first objective means that we should aim at lowering the rate of inflation—ideally to have a stable price level. The second objective is to ensure a sustainable balance of payments. This means that payments for imports from abroad or payments of interest, dividends, or profits abroad should be made without restriction.

With regard to inflation control, what is done in practice is the following. At the Central Bank, close attention is paid to what is happening in various crucial markets in the economy, especially with a medium- and long-term perspective. Obviously, the first area of focus is to look at the time-path of inflation itself; specifically, whether it is stable, accelerating, or decelerating. Attention is also paid to what is happening with overall aggregate expenditure in the economy, and, for this purpose, developments of key indicators are analyzed. For example, we must look to the rate at which imports are increasing and the rate at which the commercial banks are giving credit, as well as to occurrences in the labor market—that is to say, the tightness of the labor market must be determined. If the labor market is too tight, there may be pressures for wages to increase, which will create cost-push inflation. There is also a follow-up, of course, on developments in the financial and foreign exchange markets.

Additionally, the Central Bank observes a set of indicators that tell whether the economy is in a stable path or, for example, in the process of overheating. If it becomes apparent that some change in course is necessary, the instrument used for adjustment is the interest rate on short-term debt issued by the Central Bank. The Central Bank of Chile has an important amount of internal debt through which it indirectly influences the market interest rate. For example, if the interest rate paid in Central Bank notes is increased, private banks will be willing to pay higher interest rates on their deposits because they now have a risk-free asset that has a better return in which to invest their reserves. Additionally, in the process of increasing the interest paid on their deposits, private banks will also increase the interest charged for their loans, given a certain spread. This is the indirect way in which the Central Bank, in this example, discourages overall aggregate expenditure by the private sector. That is why I mentioned that the interest rate was not totally free, in the sense that the Central Bank has some influence on it through its open market operations. Similarly, when the

economy is slackening and there are no important inflationary pressures, the interest rate can be reduced and the process thus reversed. In a very simplified manner, this is the basic way in which the monetary policy is implemented.

For balance of payments purposes, the principal instrument used is the exchange rate. The Central Bank can intervene efficiently in the foreign exchange market, given the size of the market and the potential magnitude of the Central Bank intervention, and influence the exchange rate. Therefore, there is one criterion for the interest rate policy—inflation; and one criterion for the exchange rate policy—a sustainable balance of payments, although neither criteria nor policy instruments are totally independent of each other. To be more specific, having a sustainable balance of payments creates an exchange rate that allows the current account of the balance of payments to be financed by medium- and long-term capital. That is, we are a country that needs savings from abroad, and the way to get those foreign savings is by generating a current account deficit. This means that we must import more than we export. Yet, the amount at which we target the current account deficit should be such that we are able to finance it with stable medium- and long-term capital. We do not want to generate a situation where we have a huge current account deficit which we might be able to finance for one or two years, but which we will be unable to finance in the long run. In sum, our policy on the exchange rate concerns a sustainable current account deficit, while our policy on the interest rate concerns our role regarding inflation.

As a nation, we are aiming at maintaining and improving the positive results we have obtained in the last seven to eight years in the Chilean economy. This is a process in which we must keep close track of developments because expectations, which are crucial for investment decisions, may easily shift from a very good and optimistic mood to a depressed one. Therefore, we tend to give great weight to stability and try to avoid something that is flamboyant and exciting, but lacks a solid foundation. We do believe that stability and soundness are consistent with a dynamic economic behavior. The idea is to have a dynamic economy that can be sustained through time.

V. CONCLUSION

As to the current state of the Chilean economy, we have completed the thirty-seventh quarter of uninterrupted growth. This is something quite outstanding when you compare it with Chile's history, other countries in the region, and even other countries outside the region. Last year, the GDP increased by 10.4% in real terms, and, in the last eight years, the average increase in the GDP has been 6%. Unemployment in Chile today is at 4.4%. This is the lowest figure in twenty years—really since statistics have been available. Hence, we are near a full employment situation. As mentioned earlier, exports of goods and services represent nearly 35% of the GDP. In 1982, it was only 20% of the GDP. Furthermore, external debt has fallen from more than 100% of our GDP in 1985 to 1987, to less than 50% today. This is another clear indicator of the improving foreign sector situation of the Chilean economy. Foreign interest payments have fallen from 35% of total exports between 1985 and 1987, to less than 10% currently. In 1982, Chilean international reserves represented 15% of the country's external debt. Today, they represent 49% of external debt and more than one year of imports of goods. This also shows the solid position of our external situation.

A very interesting development in Chile's economy is that we have a fiscal budget surplus of approximately 2% of the GDP. This is also quite atypical for a developing country, and even for a developed country today. It should also be mentioned that Chileans, for the first time in many years, are investing abroad. In the last two years, we have invested more than 500 million dollars, mainly in Argentina and Peru, which are countries that are undergoing structural reforms and have gone into privatization of their public enterprises. The savings rate in Chile has also increased from less than 10% between 1982 and 1986 to nearly 20% last year. The investment rate has increased from 10% in the early 1980s to more than 20% last year. Annual inflation has fallen in the last three years from 27% to less than 13%. Thus, when you look at all the macroeconomic indicators in the Chilean economy for the last six or seven years, you really find what I would call a successful case of macroeconomic management.

I would like to conclude by saying that we are naturally quite happy with these results and are very conscious of our responsibilities in maintaining and improving them. This is very crucial be-

cause once you achieve certain results and obtain certain levels of welfare, people sometimes forget about the effort, responsibility, and care that lie behind those results, thus taking them for granted. In Chile, there is a considerable increase in consumer spending right now, because the economic situation is relatively good. Investment, employment, and real wages have also been increasing, and, thus, domestic spending is boosting aggregate demand. This could complicate further improvements in the struggle with inflation. This, of course, is a matter of great concern.

Chile has numerous challenges for the future, such as reducing poverty, improving the quality of its labor force, dealing with environmental issues, reforming government, and improving regulation without jeopardizing the benefits of competition. Another challenge relates to the need for maintaining and increasing the rate of investment. Chile has an investment rate above 20%, which is high for both Chilean and Latin-American standards generally, but still low if we expect to steadily increase the rate of output growth to reach sustainable levels of approximately 7% per year. Therefore, if we really want to leave under-development behind us, create conditions for improvement of the population on a more stable basis, obtain a higher stage of welfare, and hopefully become a developed country, the major macroeconomic challenge we face is to further increase savings and investment. This is something that requires time, patience, and constancy. These are scarce resources in many countries. The overall goal of maintaining and improving a stable, efficient, and dynamic macroeconomic framework, which is a necessary condition for increasing savings and investment, is the major challenge we will face in the upcoming years.

